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Infrastructure: Promise and Pitfalls

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Highlights

- Infrastructure seems to be the next bullet on the Democrats' policy checklist. The Democrats' infrastructure package will likely include scaled-up spending in both traditional and non-traditional items including clean energy.
- The success of infrastructure investment in boosting economic growth and job creation will depend critically on executing projects on time, on budget and avoiding costly "vanity projects".
- Lawmakers' vision of partially funding the plan through higher taxes further complicates the macro impact. Overall, the infrastructure program provides great economic potential, but may underwhelm in practice without strong implementation of the scaled-up investment budget.

Having successfully passed their US $1.9 trillion American Rescue Plan Act (ARPA), President Joe Biden and Congressional Democrats are turning their attention to infrastructure spending. Infrastructure traditionally garners bipartisan support, suggesting scope for a bipartisan bill. Acknowledging the need to invest in US infrastructure is far from a controversial position: this year, the American Society of Civil Engineers gave a "C-" grade to US transportation infrastructure, estimating an infrastructure gap in 2017 that would require about US $2.6 trillion to fill. However, a Democratic-led bill would likely include spending on non-transportation items, including broadband access, electric vehicles, and clean energy generation, with an overall price tag that could repel fiscal conservatives.

Figure 1 | Democrats' infrastructure proposals go beyond roads and bridges

Infrastructure type	House Democrats plan	Biden plan
Traditional	$863 billion	$558 billion
Non-traditional (schools, hospitals, etc.)	$350 billion	$737 billion
Clean energy and science funding	$214 billion	$967 billion
Total	**$1.49 trillion**	**$2.26 trillion**

Notes: Spending tally by Cornerstone Macro. "House Democrats Plan" refers to the Moving Forward Act (H.R. 2), "Biden Plan" is President Biden's eight-year plan unveiled on March 31. All figures in US dollars.

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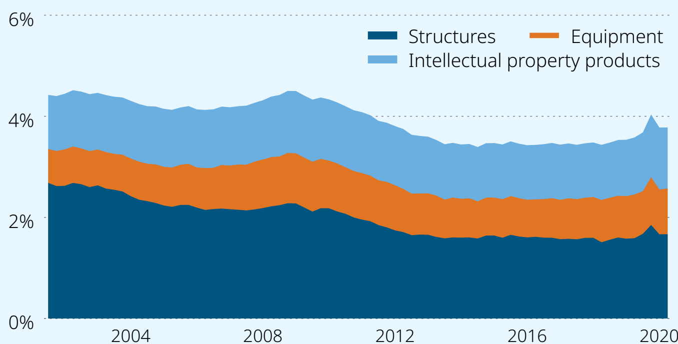
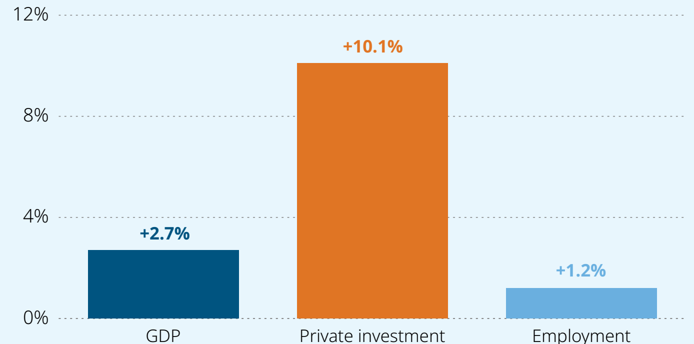
On paper, a multi-trillion infrastructure plan could be a powerful catalyst for economic growth and employment. Infrastructure investment offers short- and long-term potential benefits for the recovering US economy with positive global spillovers. In the short term, public investment can create well-paid jobs and stimulate aggregate demand, especially in times of economic weakness. Longer term, it can boost productivity growth, especially when it improves on outdated or worn out infrastructure that is restraining economic activity. In the US, where public investment in structures has decreased from 2.7% of GDP in 2002 to 1.7% of GDP in 2020 as per the Bureau of Economic Analysis, a public infrastructure upgrade could be a welcome nudge to long-term growth. On top of that, public investment can "crowd in" higher private investment, i.e., incentivize corporations to increase their investment spending, amplifying the short- and long-term effects of public investment. This is especially true in periods of greater uncertainty when public investment can act as a coordinating force. International Monetary Fund (IMF) research suggests that in uncertain times, increasing public investment by 1% of GDP can spur a 10% rise in private investment.

Figure 2 | The appealing prospect of infrastructure investment

Public investment as a % of US GDP, by type



Potential impact, over two years, of increasing public investment by 1% of GDP in times of high uncertainty



Notes: Left chart data from the Bureau of Economic Analysis as of March 31, 2021. Right chart from the IMF's October 2020 Fiscal Monitor.

But in practice, the macro impact of infrastructure programs could be disappointing without strong execution. Getting new projects off the ground is often a slow and bureaucratic process, even once funding has been approved. High-quality projects need to be identified, prioritized, and implemented effectively. Public investment plans are often plagued by poor project selection, such as political vanity projects (i.e., "roads to nowhere"). Project execution is also critical to achieve a rate of return that exceeds financing costs. An IMF study finds that advanced economies lose about 15% of returns on public investment to inefficiencies.[1] Lags in selecting and implementing projects also make infrastructure spending an unreliable tool for macro stimulus. In 2009, the US $800 billion stimulus bill of President Obama banked on "shovel-ready" projects to jumpstart the recovery. After countless delays, many projects have been abandoned, while others – notably California's high-speed rail network – remain unfinished. The 2021 infrastructure bill could face even slower implementation with non-traditional items making up a larger portion of Democratic proposals.

The 2021 infrastructure plan will also be at least partially financed through higher taxes, mainly aimed at corporations and wealthy individuals. This complicates the macro impact further. Higher corporate taxes, which lower the return to investment, discourage capital accumulation and could offset the desired "crowding in" of private investment. Firms are also more highly leveraged after the pandemic, potentially limiting their ability to increase investment. And once approved, a tax increase can be implemented much faster than a large national infrastructure plan. Plus, if the impact of new infrastructure on long-term growth disappoints, the US debt-to-GDP ratio could deteriorate. The government may need to raise taxes or cut spending further, setting a bearish backdrop for markets.

For all these reasons, scaled-up infrastructure spending may underwhelm currently high investor expectations. In 2016, markets reacted to Donald Trump's surprise election by selling bonds, in part from the anticipation of a large infrastructure program. The spending never materialized. That episode could end up being a cautionary tale for President Biden's turn on the infrastructure carousel.

1 IMF, Public Investment Management Assessment: Strengthening Infrastructure Governance, 2019.

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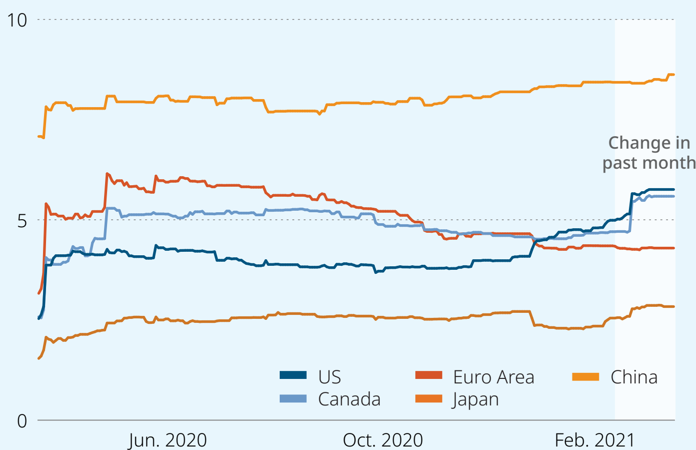
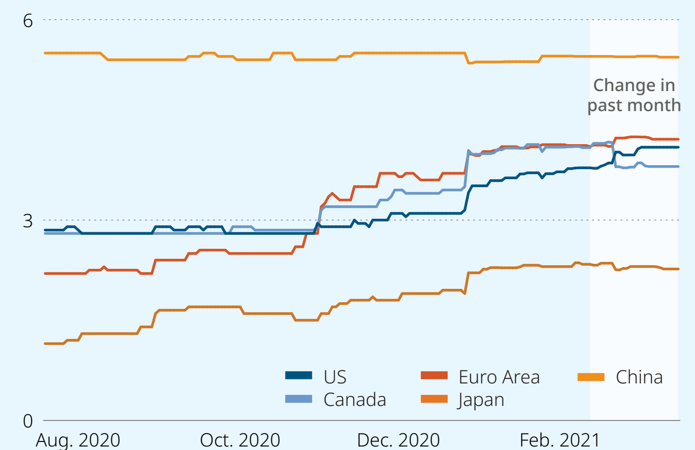
Global macro update

- Continuing their upwards trend from recent months, **US** growth and inflation expectations climbed in March as Congress passed a $1.9 trillion stimulus plan, close to 30% of Americans have received at least one vaccine dose, and a large infrastructure package is on the table.
- Similarly, 2021 consensus GDP growth and inflation forecasts for **Canada** both climbed higher. An accelerating pace of vaccination pulled forward reflation expectations to 2021 and the US fiscal stimulus package should boost Canadian exports and investment spending.
- **Global** inflation is forecast to be slightly higher in 2021, in part due to emerging supply-side constraints driving up cost pressures. A worldwide semi-conductor shortage, a possible China/Europe trade spat and the week-long obstruction of the Suez Canal could contribute to temporarily higher inflation.

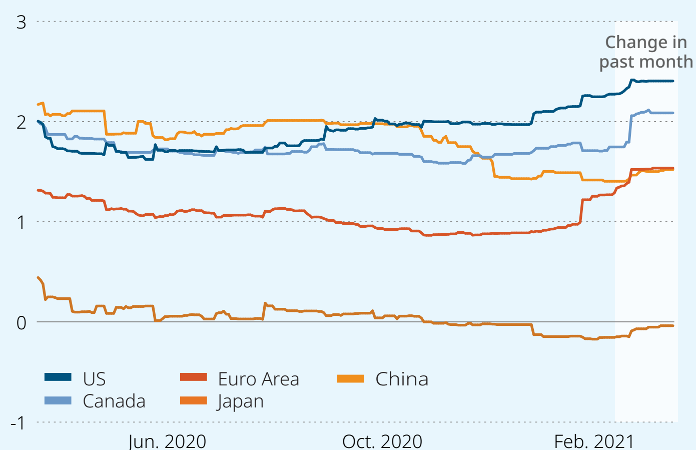
2021 real GDP growth forecast (%, consensus)



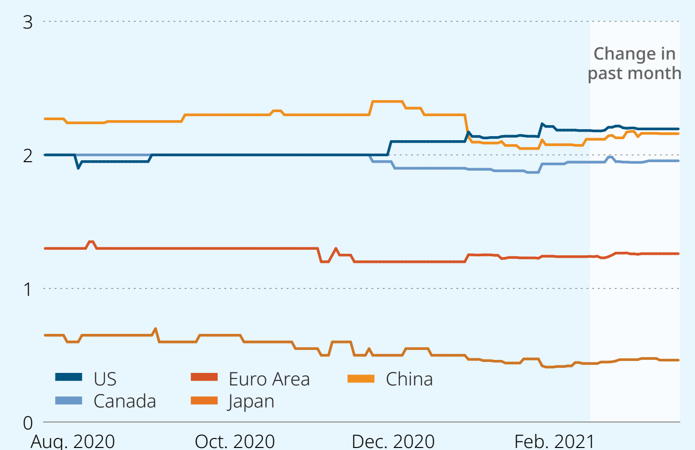
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



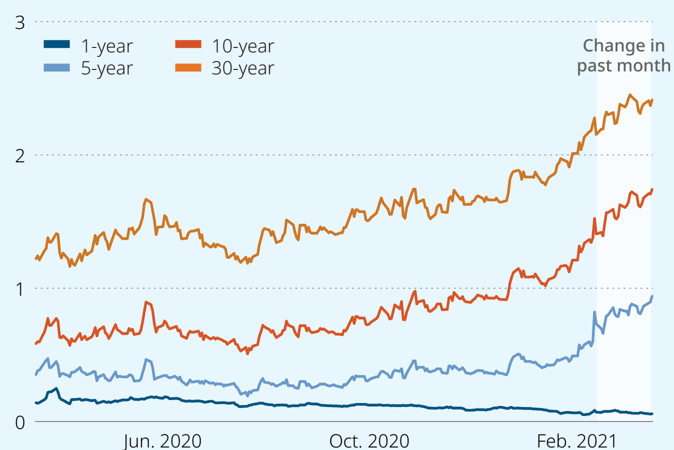
Source: 2021 forecast survey from Consensus Economics, 2022 forecast survey from Bloomberg, as of March 31 2021.

Capital markets update

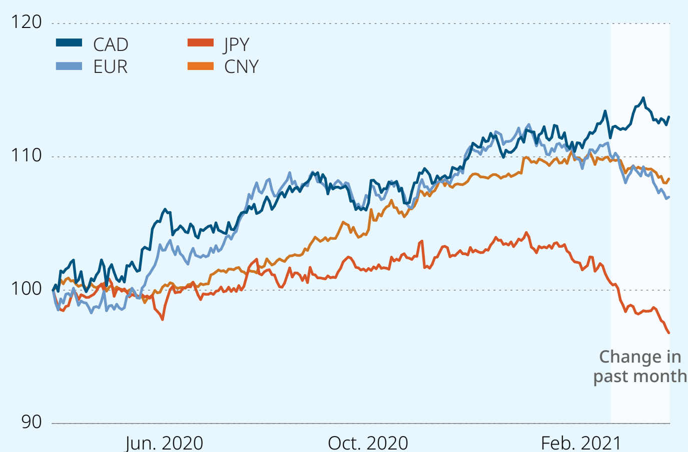
- After an eventful month in February, the **US yield curve** further steepened in March. The Federal Reserve kept its policy stance unchanged at its March 17 meeting and did not push back against climbing long-term yields. It also let a key regulatory exemption expire, a move which at the margin should reduce American banks' Treasury bond holdings.
- **Emerging market** stocks were dragged down by expectations of a tightening in China's monetary and fiscal policies. Chinese officials dropped their 2021 GDP growth target to 6%, well below consensus expectations, which also contributed to the **yuan** depreciating in March.
- The **Canadian dollar** outperformed all major currencies this month. As a pro-cyclical currency with strong ties to the US, it likely benefitted from the adoption of the US stimulus plan.

Equity indices (one year ago=100)

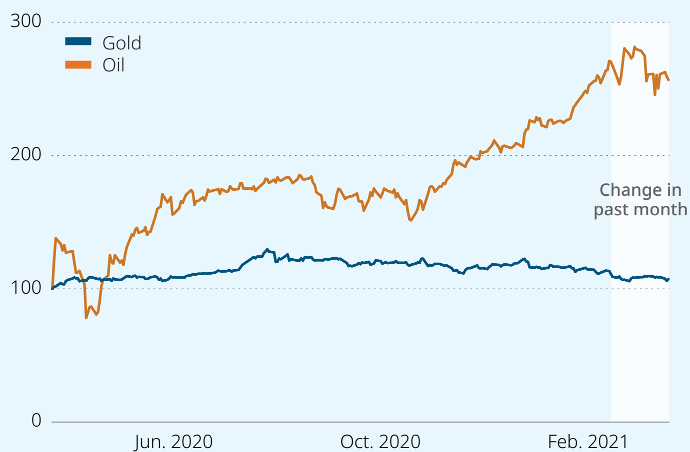
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD, one year ago=100)



Source: Via Bloomberg as of March 31 2021.

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What we'll be watching in April

April 13: US March CPI release

- The March CPI release, coming one year after the Covid disinflation shock, could mark the beginning of a jump in year-on-year inflation due to "base effects" rolling out of the calculation.
- Combining base effects with pressures from surging commodity prices, we could observe inflation rising above 2% for the first time since February 2020. With the Fed forecasting 2.2% annual core inflation in 2021 without an expected rate hike until 2024, the Federal Reserve has signalled that it won't react to temporary above-target inflation.

April 19: Canada federal budget unveiled

- The first federal budget in two years will likely contain sizable stimulus measures to jumpstart the post-Covid recovery. The government already signalled it would not raise new taxes or cut spending. We'll be curious to see whether it introduces a new fiscal anchor.

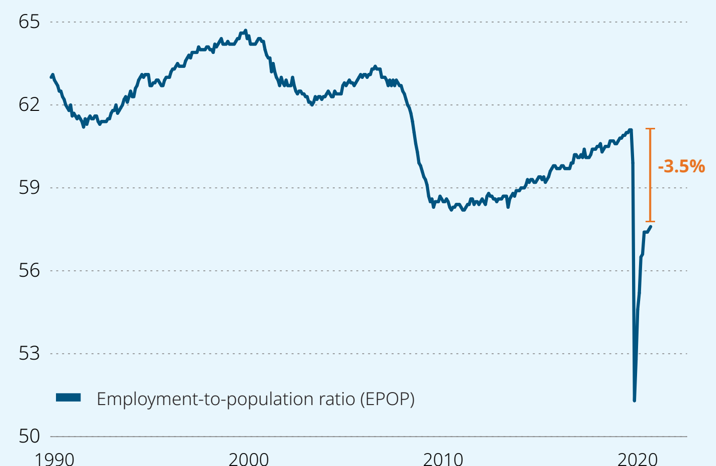
April 21: BoC rate decision and MPR

- The Bank of Canada is expected to begin tightening its policy stance earlier than the Fed.
- The BoC could begin tapering asset purchases as soon as April, after recently announcing the winding down of emergency liquidity facilities. It currently owns 35% of all outstanding Canadian government bonds, close to double the proportion of the Fed's ownership of Treasuries.

Emerging theme

- Recently, pushing back against taper talk, Fed Chair Jerome Powell has emphasized his goal of getting the US back to "**maximum employment**".
- Employment now boasts a broader definition than in the past. Rather than fixating on the unemployment rate, policy makers look at **more comprehensive and inclusive measures of joblessness**. Powell has singled out the employment-to-population ratio (EPOP) as a benchmark. It is still well below its February 2020 level, let alone its pre-2008 crest.
- **Discouraged workers and the permanently jobless** fall out of the labour market entirely and do not show up in standard unemployment data. Running the economy hot, past the point where the unemployment rate is "back to normal", could help draw these marginalized workers back into the labour force.
- To have any hope of **predicting the path of US rates**, investors must pay attention to these broad employment measures, which are now key variables in the Fed's reaction function.

Broad measures show the US still well below full employment



Source: Bloomberg February 28, 2021

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Appendix:
Capital market returns in March

Category	Asset	Return
Major Asset Classes	Global Equity	4.21%
	Global Bonds	-1.89%
Regional Equity (local)	S&P 500	4.38%
	TSX	4.40%
	Nikkei	2.08%
	FTSE 100	4.91%
	EuroStoxx 50	8.28%
	MSCI EM	-1.51%
Styles	US Small Cap - Large Cap	-2.65%
	US Value - Growth	4.04%
Sovereigns	USA 10-year Treasury Future	-1.21%
	CAN 10-year Gov't Bond Future	-0.29%
	GBR 10-year Gilt Future	0.05%
	DEU 10-year Bund Future	0.53%
	JPN 10-year JGB Future	0.41%
Fixed Income	US High Yield Bonds	0.17%
	US Investment Grade Bonds	-1.26%
	US Leveraged Loans	-0.31%
	CA Provincial Bonds	-2.42%
	CA Corporate Bonds	-1.04%
	CA Inflation-Linked Bonds	-0.52%
Alt	Gold	-1.12%
	Oil	-2.05%
	Global REIT	5.91%
	Global Infrastructure	7.49%
FX Spot	CAD/USD	1.27%
	GBP/USD	-1.15%
	EUR/USD	-2.78%
	JPY/USD	-3.83%

-5 0 5 10

Source: Market data from Bloomberg as of March 31 2021. Index returns are for the period: 2021-03-01 to 2021-03-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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